

1 FINANCE AND ADMINISTRATION CABINET

2 Department of Revenue

3 (New Administrative Regulation)

4 103 KAR 16:400. Combined Unitary Kentucky corporation income tax return.

5 RELATES TO: KRS 141.120, 141.121, 141.202

6 STATUTORY AUTHORITY: KRS 131.130(1), 141.050(4)

7 NECESSITY, FUNCTION, AND CONFORMITY: KRS 141.202 sets forth the general rules  
8 for combined unitary reporting in Kentucky. KRS 131.130(1) authorizes the Department of  
9 Revenue to promulgate administrative regulations necessary to administer and enforce Kentucky's  
10 tax laws. KRS 141.050(4) requires the Department of Revenue to promulgate administrative  
11 regulations and rules necessary for the proper administration of KRS Chapter 141. This  
12 administrative regulation establishes terms and procedures required for the implementation of  
13 combined unitary reporting in KRS 141.202.

14 Section 1. Definitions.

15 (1) "Combined group" is defined by KRS 141.202 (2)(a).

16 (2) "Corporation" is defined by KRS 141.202(2)(b).

17 (3) "Designated Filer" means the taxpayer member of the combined group annually  
18 designated per KRS 141.202(9) to file the return.

19 (3) "Doing business in this state" is defined by KRS 141.010(7).

20 (4) "Person" is defined by KRS 141.010 (23).

21 (5) "Taxpayer" is defined by KRS 141.202 (2)(e).

1 (6) "Unitary Business" is defined by KRS 141.202(2)(f).

2 (7) "Waters-edge basis" means the corporations required to be included in the combined group  
3 pursuant to KRS 141.202(8).

4 Section 2. Fifty (50) Percent Ownership Test

5 (1) Separate corporations can be part of a combined group only if they meet the fifty (50)  
6 percent ownership test in KRS 141.202(2)(a).

7 (a) The fifty (50) percent test is satisfied in the following circumstances:

8 1. A parent corporation and one (1) or more corporations or chains of corporations which are  
9 connected through voting stock ownership with the parent, whether such ownership is direct or  
10 indirect, but only if:

11 a. The parent owns more than fifty (50) percent of the outstanding voting stock of at least one  
12 corporation, and, if applicable,

13 b. More than fifty (50) percent of the outstanding voting stock of each of the corporations,  
14 other than the parent, is owned by the parent, one (1) or more corporations owned by the parent as  
15 described in subparagraph (a) above, or one (1) or more corporations that satisfy the conditions of  
16 this subparagraph.

17 2. Any two (2) or more corporations, if over fifty (50) percent of the outstanding voting stock  
18 of each of the corporations is owned, or indirectly owned, by the same person.

19 3. Any two (2) or more corporations, over fifty (50) percent of whose voting stock is  
20 cumulatively owned (without regard to the indirect ownership rules described below in paragraph

21 (b)1. by, or for the benefit of, members of the same family. Members of the same family are limited  
22 to an individual, his or her spouse, parents, brothers or sisters, grandparents, children and  
23 grandchildren, and their respective spouses.

1 (b) Except as otherwise provided, voting stock is "owned" when title to the stock is directly  
2 held or if the voting stock is indirectly owned. The stock attribution rules of Section 318(a) of the  
3 Internal Revenue Code, 26 U.S.C. 318, shall be used to determine if the voting stock is indirectly  
4 owned except when a person has an option to acquire stock or other ownership interests in an  
5 entity, the stock or ownership interests are not considered owned by the person unless the  
6 department determines it to be necessary to prevent tax avoidance.

7 (c) In determining ownership, effective control over election of the board of directors shall be  
8 considered. For example, a group of shareholders acting in concert who collectively own over fifty  
9 (50) percent of the voting stock of each of two (2) or more corporations shall be considered to be  
10 common owners of more than fifty (50) percent of the voting stock of each of those corporations.  
11 "Voting stock" refers only to those shares of voting stock having the power to elect the  
12 corporation's board of directors. If the power otherwise held in corporate stock to vote the  
13 membership of the board is transferred to another, other than a transfer of proxy only, the holder  
14 of that power shall be considered to be the owner of that stock to the exclusion of the transferor of  
15 such power.

16 (d) In addition to the tests in paragraph (a), the Department may consider any other  
17 circumstance that tends to demonstrate that the fifty (50) percent direct or indirect common  
18 ownership test was met, or was not met.

19 (e) Membership in a combined group shall be treated as terminated in any year, or fraction  
20 thereof, in which the conditions of paragraph (a) are not met, except as follows:

21 1. When stock of a corporation is sold, exchanged, or otherwise disposed of, the membership  
22 of a corporation in a combined group shall not be terminated if the requirements of paragraph (a)  
23 are again met immediately after the sale, exchange, or disposition.

1        2. The Department may treat the combined group as remaining in place if the conditions of  
2 paragraph (a) are again met within a period not to exceed two years.

3        Section 3. Unitary Business Principle.

4        (1) The Concept of a Unitary Business.

5        (a) The flow of value to an entity located in this state that comes from being part of a unitary  
6 business conducted both within and without this state is what provides the constitutional due  
7 process "definite link and minimum connection" necessary for this state to apportion  
8 apportionable income of the unitary business, even if that income arises in part from activities  
9 conducted outside the state.

10       (b) This sharing or exchange of value may also be described as requiring that the operation of  
11 one part of the business be dependent upon, or contribute to, the operation of another part of the  
12 business. Phrased in the disjunctive, the foregoing means that if the activities of one business  
13 either contributes to the activities of another business or are dependent upon the activities of  
14 another business, those businesses are part of a unitary business.

15       (2) Constitutional Requirement for a Unitary Business.

16       (a) The sharing or exchange of value described in KRS 141.202(2)(f) and subsection 1 that  
17 defines the scope of a unitary business requires more than the mere flow of funds arising out of a  
18 passive investment or from the financial strength contributed by a distinct business undertaking  
19 that has no operational relationship to the unitary business.

20       (b) In this state, the unitary business principle shall be applied to the full extent allowed by  
21 the U.S. Constitution. The unitary business principle shall not be applied to result in the  
22 combination of business activities or entities under circumstances where, if it were adverse to the  
23 taxpayer, the combination of such activities or entities would not be allowed by the U.S.

1 Constitution.

2 (3) Separate Trades or Businesses Conducted within a Single Entity. A single entity may have  
3 more than one (1) unitary business. In such cases, it is necessary to determine the apportionable  
4 income attributable to each separate unitary business as well as its non-apportionable income,  
5 which is specifically allocated. The apportionable income of each unitary business is then  
6 apportioned by a formula that takes into consideration the in-state and the out-of-state factors that  
7 relate to the respective unitary business whose income is being apportioned.

8 (4) Unitary Business Unaffected by Formal Business Organization. A unitary business may  
9 exist within a single entity or among a group of entities meeting the fifty (50) percent ownership  
10 test in KRS 141.202(2)(a) and in Section 2 of this administrative regulation.

11 Section 4. Determination of a Unitary Business.

12 (1) A unitary business is characterized by significant flows of value evidenced by factors such  
13 as functional integration, centralization of management, and economies of scale. These factors  
14 provide evidence of whether the business activities operate as an integrated whole or exhibit  
15 substantial mutual interdependence. Facts suggesting the presence of the factors mentioned above  
16 should be analyzed in combination for their cumulative effect and not in isolation. A particular  
17 business operation may be suggestive of one (1) or more of the factors mentioned above.

18 (2) Description and Illustration of Functional Integration, Centralization of Management and  
19 Economies of Scale.

20 (a) Functional integration: Functional integration refers to transfers between, or pooling  
21 among, business activities that significantly affect the operation of the business activities.  
22 Functional integration includes, but is not limited to, transfers or pooling with respect to the  
23 unitary business's products or services, technical information, marketing information, distribution

1 systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, trade  
2 secrets, know-how, formulas, and processes. There is no specific type of functional integration  
3 that must be present. The following is a list of examples of business operations that can support  
4 the finding of functional integration. The order of the list does not establish a hierarchy of  
5 importance.

6 1. Sales, exchanges, or transfers (collectively "sales") of products, services, or intangibles  
7 between business activities provide evidence of functional integration. The significance of the  
8 intercompany sales to the finding of functional integration shall be affected by the character of  
9 what is sold or the percentage of total sales or purchases represented by the intercompany sales.  
10 For example, sales among entities that are part of a vertically integrated unitary business are  
11 indicative of functional integration. Functional integration is not negated by the use of a readily  
12 determinable market price to effect the intercompany sales, because such sales can represent an  
13 assured market for the seller or an assured source of supply for the purchaser.

14 2. Common Marketing. The sharing of common marketing features among entities is an  
15 indication of functional integration when such marketing results in significant mutual advantage.  
16 Common marketing exists when a substantial portion of the entities' products, services, or  
17 intangibles are distributed or sold to a common customer, when the entities use a common trade  
18 name or other common identification, or when the entities seek to identify themselves to their  
19 customers as a member of the same enterprise. The use of a common advertising agency or a  
20 commonly owned or controlled in-house advertising office does not by itself establish common  
21 marketing that is suggestive of functional integration. Such activity, however, is relevant to  
22 determining the existence of economies of scale or centralization of management.

23 3. Transfer or Pooling of Technical Information or Intellectual Property. Transfers or pooling

1 of technical information or intellectual property, such as patents, copyrights, trademarks and  
2 service marks, trade secrets, processes or formulas, know-how, research, or development, provide  
3 evidence of functional integration when the matter transferred is significant to the businesses'  
4 operations.

5 4. Common Distribution System. Use of a common distribution system by the entities, under  
6 which inventory control and accounting, storage, trafficking, or transportation are controlled  
7 through a common network provides evidence of functional integration.

8 5. Common Purchasing. Common purchasing of substantial quantities of products, services,  
9 or intangibles from the same source by the entities, particularly where the purchasing results in  
10 significant cost savings or where the products, services or intangibles are not readily available  
11 from other sources and are significant to each entity's operations or sales, provides evidence of  
12 functional integration.

13 6. Common or Intercompany Financing. Significant common or intercompany financing,  
14 including the guarantee by, or the pledging of the credit of, one (1) or more entities for the benefit  
15 of another entity or entities provides evidence of functional integration, if the financing activity  
16 serves an operational purpose of both borrower and lender. Lending which serves an investment  
17 purpose of the lender does not necessarily provide evidence of functional integration.

18 (b) Centralization of Management. Centralization of management exists when directors,  
19 officers, or other management employees jointly participate in the management decisions that  
20 affect the respective business activities and that may also operate to the benefit of the entire  
21 economic enterprise. Centralization of management can exist whether the centralization is effected  
22 from a parent entity to a subsidiary entity, from a subsidiary entity to a parent entity, from one (1)  
23 subsidiary entity to another, from one (1) division within a single entity to another division within

1 an entity, or from any combination of the foregoing. Centralization of management may exist even  
2 when day-to-day management responsibility and accountability has been decentralized, so long  
3 as the management has an ongoing operational role with respect to the business activities. An  
4 operational role can be effected through mandates, consensus building, or an overall operational  
5 strategy of the business, or any other mechanism that establishes joint management.

6 1. Facts Providing Evidence of Centralization of Management. Evidence of centralization of  
7 management is provided when common officers participate in the decisions relating to the  
8 business operations of the different segments. Centralization of management may exist when  
9 management shares or applies knowledge and expertise among the parts of the business. Existence  
10 of common officers and directors, while relevant to a showing of centralization of management,  
11 does not alone provide evidence of centralization of management. Common officers are more  
12 likely to provide evidence of centralization of management than are common directors.

13 2. Stewardship Distinguished. Centralized efforts to fulfill stewardship oversight are not  
14 evidence of centralization of management. Stewardship oversight consists of those activities that  
15 any owner would take to review the performance of or safeguard an investment. Stewardship  
16 oversight is distinguished from those activities that an owner may take to enhance value by  
17 integrating one (1) or more significant operating aspects of one business activity with the other  
18 business activities of the owner. For example, implementing reporting requirements or mere  
19 approval of capital expenditures may evidence only stewardship oversight.

20 (c) Economies of Scale. Economies of scale refer to a relation among and between business  
21 activities resulting in a significant decrease in the average per unit cost of operational or  
22 administrative functions due to the increase in operational size. Economies of scale may exist  
23 from the inherent cost savings that arise from the presence of functional integration or

1 centralization of management. The following are examples of business operations that can support  
2 the finding of economies of scale. The order of the list does not establish a hierarchy of  
3 importance.

4 1. Centralized Purchasing. Centralized purchasing designed to achieve savings due to the  
5 volume of purchases, the timing of purchases, or the interchangeability of purchased items among  
6 the parts of the business engaging in the purchasing provides evidence of economies of scale.

7 2. Centralized Administrative Functions. The performance of traditional corporate  
8 administrative functions in common, such as legal services, payroll services, pension and other  
9 employee benefit administration, among the parts of the business may result in some degree of  
10 economies of scale. An entity that secures savings in the performance of corporate administrative  
11 services due to its affiliation with other entities that it would not otherwise reasonably be able to  
12 secure on its own because of its size, financial resources, or available market, provides evidence  
13 of economies of scale.

#### 14 Section 5. Indicators of a Unitary Business.

15 (1) Same Type of Business. Business activities that are in the same general line of business  
16 generally constitute a single unitary business, as, for example, a multistate grocery chain.

17 (2) Steps in a Vertical Process. Business activities that are part of different steps in a vertically  
18 structured business almost always constitute a single unitary business. For example, a business  
19 engaged in the exploration, development, extraction, and processing of a natural resource and the  
20 subsequent sale of a product based upon the extracted natural resource, is engaged in a single  
21 unitary business, regardless of the fact that the various steps in the process are operated  
22 substantially independently of each other with only general supervision from the business's  
23 executive offices.

(3) Strong Centralized Management. Business activities which might otherwise be considered as part of more than one (1) unitary business may constitute one (1) unitary business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Strong centralized management exists when a central manager or group of managers makes substantially all of the operational decisions of the business. For example, some businesses conducting diverse lines of business may properly be considered as engaged in only one unitary business when the central executive officers are actively involved in the operations of the various business activities and there are centralized offices which perform for the business activities the normal matters which a truly independent business would perform for itself, such as personnel, purchasing, advertising, or financing.

Section 6. Taxable year of the combined group.

(1) The combined group's taxable year is determined as follows:

(a) If two (2) or more members of a group file a federal consolidated return, the combined group's taxable year is the taxable year of the federal consolidated group; or

(b) In all other cases, the taxable year is the taxable year of the designated filer.

Section 7. Members with different accounting periods.

(1) If the taxable year of a member differs from the taxable year of the combined group, the designated filer shall elect to determine the portion of that member's income to be included in one (1) of the following ways:

(a) A separate income statement prepared from the books and records for the months included in the combined group's taxable year; or

(b) Including all of the income for the year that ends during the combined group's taxable year.

1 (2) The same method shall be used for each member with a different accounting period. Once  
2 an election is made under this section by attaching a statement to the return, it is the only method  
3 that may be used with respect to members of the combined group except upon prior approval by  
4 the Department.

5 Section 8. Designated Filer (1) Responsibilities of designated filer.

6 (a) Access to records. In addition to the information required to be included in the combined  
7 group return, upon request of the Department, the designated filer shall provide access to:

8 1. The tax and financial records of members of the combined group that are part of the  
9 combined group but do not have Kentucky nexus, and

10 2. Non-financial records of the combined group.

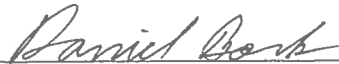
11 (b) Filing. The designated filer shall file a combined group return on behalf of the combined  
12 group together with all returns and schedules required by the Department.

13 (c) Payment. The designated filer shall timely remit to the department the Kentucky corporate  
14 income and limited liability entity tax imposed on the combined Kentucky net income and receipts  
15 of the combined group.

16 (d) Notices. Notices mailed to the designated filer shall be deemed to have been mailed to each  
17 of the members in the combined group.

103 KAR 16:400

APPROVED:

  
\_\_\_\_\_  
DANIEL BORK, COMMISSIONER  
Department of Revenue  
Finance and Administration Cabinet

JUNE 6, 2019  
\_\_\_\_\_  
DATE APPROVED BY AGENCY

## PUBLIC HEARING AND PUBLIC COMMENT PERIOD

A public hearing on this administrative regulation shall be held on July 25, 2019 at 10:00 a.m. in Room 9B, State Office Building, 501 High Street, Frankfort KY 40601. Individuals interested in being heard at this hearing shall notify this agency in writing by five (5) workdays prior to the hearing, of their intent to attend. If no notification of intent to attend the hearing is received by that date, the hearing may be cancelled. This hearing is open to the public. Any person who wishes to be heard will be given an opportunity to comment on the proposed administrative regulation. A transcript of the public hearing will not be made unless a written request for a transcript is made. If you do not wish to be heard at the public hearing, you may submit written comments on the proposed administrative regulation. Written comments shall be accepted through July 31, 2019. Send written notification of intent to be heard at the public hearing or written comments on the proposed administrative regulation to the contact person.

CONTACT PERSON: Todd Renner, Executive Director, Office of Tax Policy and Regulation, Department of Revenue, 501 High Street, Station 1, Frankfort, Kentucky, 40601, (502) 782-6081 (telephone), (502) 564-3875(fax), [Todd.Renner@ky.gov](mailto:Todd.Renner@ky.gov)(email).

## REGULATORY IMPACT ANALYSIS AND TIERING STATEMENT

Regulation Number: 103 KAR 16:400

Contact Person: Todd Renner

Phone Number: (502) 782-6081

Email: Todd.Renner@ky.gov

(1) Provide a brief summary of:

(a) What this administrative regulation does: This administrative regulation provides guidance on the filing of a combined unitary Kentucky corporation income tax return under the provisions of KRS 141.202, as enacted by 2018 HB 487 and amended by 2019 HB 458.

(b) The necessity of this administrative regulation: This regulation provides guidance on how to file a combined unitary Kentucky corporation income tax return.

(c) How this administrative regulation conforms to the content of the authorizing statutes: It provides guidance on how to file a combined unitary Kentucky corporation income tax return for taxable years beginning on or after January 1, 2019.

(d) How this administrative regulation currently assists or will assist in the effective administration of the statutes: This regulation will provide guidance to insure that corporations required to file a combined unitary Kentucky corporation income tax return under KRS 141.202 will do so accurately.

(2) If this is an amendment to an existing administrative regulation, provide a brief summary of:

(a) How the amendment will change this existing administrative regulation: This is a new administrative regulation.

(b) The necessity of the amendment to this administrative regulation: Not applicable

(c) How the amendment conforms to the content of the authorizing statutes: Not applicable.

(d) How the amendment will assist in the effective administration of the statutes: Not applicable.

(3) List the type and number of individuals, businesses, organizations, or state and local governments affected by this administrative regulation: Corporations required to file a combined unitary Kentucky corporation income tax return under KRS 141.202 for taxable years beginning on or after January 1, 2019 will be affected.

(4) Provide an analysis of how the entities identified in question (3) will be impacted by either the implementation of this administrative regulation, if new, or by the change, if it is an amendment, including:

(a) List the actions that each of the regulated entities identified in question (3) will have to take to comply with this administrative regulation or amendment: Corporations that are members of a combined group will have to file a combined unitary Kentucky corporation income tax return under the provisions of KRS 141.202 and this administrative regulation.

(b) In complying with this administrative regulation or amendment, how much will it cost each of the entities identified in question (3): The cost to impacted taxpayers is unknown because combined unitary Kentucky corporation income tax reporting is a new filing requirement for returns due for taxable years beginning on or after January 1, 2019.

(c) As a result of compliance, what benefits will accrue to the entities identified in question (3): Complying with this administrative regulation will help insure that an accurate income tax return is filed by the corporate entities identified in question (3).

(5) Provide an estimate of how much it will cost to implement this administrative regulation:

(a) Initially: A cost increase for the Department of Revenue will occur. The increase is indeterminable since the department cannot predict how many taxpayers will be required to file a combined unitary Kentucky corporation income tax return under the new law.

(b) On a continuing basis: Indeterminable.

(6) What is the source of the funding to be used for the implementation and enforcement of this administrative regulation: The cost to implement will be paid for out of the department's existing budget.

(7) Provide an assessment of whether an increase in fees or funding will be necessary to implement this administrative regulation, if new, or by the change, if it is an amendment: No increase is necessary.

(8) State whether or not this administrative regulation establishes any fees or directly or indirectly increases any fees: No fees are established or increased by this administrative regulation.

(9) TIERING: Is tiering applied? Tiering was not applied because all corporation income taxpayers required to file a combined unitary Kentucky corporation income tax return will be able to do so under this administrative regulation.

## FISCAL NOTE ON STATE OR LOCAL GOVERNMENT

Regulation Number: 103 KAR 16:400

Contact Person: Todd Renner

Phone Number: (502) 782-6081

Email: Todd.Renner@ky.gov

1. What units, parts or divisions of state or local government (including cities, counties, fire departments, or school districts) will be impacted by this administrative regulation? The Department of Revenue.

2. Identify each state or federal statute or federal regulation that requires or authorizes the action taken by the administrative regulation. KRS 131.130 and KRS 141.050.

3. Estimate the effect of this administrative regulation on the expenditures and revenues of a state or local government agency (including cities, counties, fire departments, or school districts) for the first full year the administrative regulation is to be in effect. There will be minimal effect on the Department of Revenue. The Office of the State Budget Director will be impacted slightly in their revenue estimation duties since combined unitary Kentucky corporation income tax returns are a new type of return for 2019 forward. There is no local government impact.

(a) How much revenue will this administrative regulation generate for the state or local government (including cities, counties, fire departments, or school districts) for the first year? Unknown.

(b) How much revenue will this administrative regulation generate for the state or local government (including cities, counties, fire departments, or school districts) for subsequent years? Unknown.

(c) How much will it cost to administer this program for the first year? Minimal costs to administer for the first year. The exact amount is indeterminable since the Department of Revenue cannot predict how many taxpayers will elect to file a combined unitary Kentucky corporation income tax return.

(d) How much will it cost to administer this program for subsequent years? The exact amount is indeterminable since the Department of Revenue cannot predict how many taxpayers will elect to file a combined unitary Kentucky corporation income tax returns in subsequent years.

Note: If specific dollar estimates cannot be determined, provide a brief narrative to explain the fiscal impact of the administrative regulation.

Revenues (+/-):

Expenditures (+/-):

Other Explanation: